

§ 1.861-6

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royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, in the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States. For taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of § 1.871-11.

[T.D. 7378, 40 FR 45434, Oct. 2, 1975]

§ 1.861-6 Sale of real property.

Gross income from sources within the United States includes gain, computed under the provisions of section 1001 and the regulations thereunder, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder.

§ 1.861-7 Sale of personal property.

(a) *General.* Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

(b) *Purchase within a possession.* Notwithstanding paragraph (a) of this section, income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources with-

in and partly from sources without the United States. See section 863(b)(3) and § 1.863-2.

(c) *Country in which sold.* For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(d) *Production and sale.* For provisions respecting the source of income derived from the sale of personal property produced by the taxpayer, see section 863(b)(2) and paragraphs (b) of §§ 1.863-1 and 1.863-2.

(e) *Section 306 stock.* For determining the source of gain on the disposition of section 306 stock, see section 306(f) and the regulations thereunder.

§ 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) *In general—(1) Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code

sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as “deductions”) of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections.

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(3) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income.

(3) *Class of gross income.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a “class of gross income” and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61, namely:

- (i) Compensation for services, including fees, commissions, and similar items;
- (ii) Gross income derived from business;
- (iii) Gains derived from dealings in property;
- (iv) Interest;
- (v) Rents;
- (vi) Royalties;
- (vii) Dividends;
- (viii) Alimony and separate maintenance payments;

- (ix) Annuities;
- (x) Income from life insurance and endowment contracts;
- (xi) Pensions;
- (xii) Income from discharge of indebtedness;
- (xiii) Distributive share of partnership gross income;
- (xiv) Income in respect of a decedent;
- (xv) Income from an interest in an estate or trust.

(4) *Statutory grouping of gross income and residual grouping of gross income.* For purposes of this section, the term “statutory grouping of gross income” or “statutory grouping” means the gross income from a specific source or activity which must first be determined in order to arrive at “taxable income” from which specific source or activity under an operative section. (See paragraph (f)(1) of this section.) Gross income from other sources or activities is referred to as the “residual grouping of gross income” or “residual grouping.” In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income. See paragraph (d)(2) of this section with respect to the allocation and apportionment of deductions to excluded income.

(b) *Allocation—(1) In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a “class of gross income” and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income

are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) *Relationship to activity or property.* A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example 17 of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In

such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated or could reasonably be expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) to expenses other than expenses attributable to stewardship activities, see *Examples 19* through *21* of paragraph (g) of this section. See paragraph (e)(4)(ii) of this section for the allocation and apportionment of deductions attributable to stewardship expenses. However, supportive deductions that are described in § 1.861-14T(e)(3) shall be allocated and apportioned in accordance with the rules of § 1.861-14T and shall not be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in § 1.861-14T(d).

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) *Deductions related to all gross income.* If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) *Apportionment of deductions—(1) Deductions definitely related to a class of*

gross income. [Reserved]. For guidance, see § 1.861-8T(c)(1).

(2) *Apportionment based on assets.* Certain taxpayers are required by paragraph (e)(2) of this section and § 1.861-9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that this method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of § 1.861-9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or, except in the case of interest expense, on the basis of their fair market value. See § 1.861-9(h). Taxpayers using the fair market value method for their last taxable year beginning before January 1, 2018, must change to the tax book value method (or the alternative tax book value method) for purposes of apportioning interest expense for their first taxable year beginning after December 31, 2017. The Commissioner's approval is not required for this change. In the case of any corporate taxpayer that both uses tax book value or alternative tax book value, and owns directly or indirectly (within the meaning of § 1.861-12T(c)(2)(ii)(B)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), the taxpayer must adjust its basis in that stock in the manner described in § 1.861-12(c)(2). For the definition of related persons formerly contained in § 1.861-8T(c)(2), see paragraph (c)(4) of this section.

(3) *Deductions not definitely related to any gross income.* If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The

amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross income in the residual grouping bears to the total amount of gross income.

(4) *Cross-referenced definition of related persons.* The term related persons means two or more persons in a relationship described in section 267(b). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned by with the application of section 1563(e)(1), and stock owned by application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(d) *Excess of deductions and excluded and eliminated income*—(1) *Excess of deductions.* Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is

taken into account in determining the consolidated taxable income from the residual grouping. See § 1.1502-4(d)(1) and the last sentence of § 1.1502-12. For an illustration of the principles of this paragraph (d)(1), see example 17 of paragraph (g) of this section.

(2) *Allocation and apportionment to exempt, excluded, or eliminated income*—(i) *In general.* For further guidance, see § 1.861-8T(d)(2)(i).

(ii) *Exempt income and exempt asset defined*—(A) *In general.* For purposes of this section, the term *exempt income* means any gross income to the extent that it is exempt, excluded, or eliminated for Federal income tax purposes. The term *exempt asset* means any asset to the extent income from the asset is (or is treated as under paragraph (d)(2)(ii)(B) or (C) of this section) exempt, excluded, or eliminated for Federal income tax purposes.

(B) *Certain stock and dividends.* For further guidance, see § 1.861-8T(d)(2)(ii)(B).

(C) *Foreign-derived intangible income and inclusions under section 951A(a)*—(I) *Exempt income.* The term “exempt income” includes an amount of a domestic corporation’s gross income included in gross foreign-derived deduction eligible income (or gross FDDEI), and also includes an amount of a domestic corporation’s gross income from an inclusion under section 951A(a) and the gross up under section 78 attributable to such an inclusion, in each case equal to the amount of the deduction allowed under section 250(a) for such gross income (taking into account the reduction under section 250(a)(2)(B), if any). Therefore, for purposes of apportioning deductions using a gross income method, gross income does not include gross income included in gross FDDEI, an inclusion under section 951A(a), or the gross up under section 78 attributable to an inclusion under section 951A(a), in an amount equal to the amount of the deduction allowed under section 250(a)(1)(A), (B)(i), or (B)(ii), respectively (taking into account the reduction under section 250(a)(2)(B), if any). The term *gross foreign-derived deduction eligible income*, or *gross FDDEI*, means the portion of the domestic corporation’s gross income (determined without regard to the amounts described in

section 250(b)(3)(A)(i)(I) through (VI)) that is derived from sales and services described in section 250(b)(4)(A) and (B).

(2) *Exempt assets*—(i) *Assets that produce foreign-derived intangible income.* The term “exempt asset” includes the portion of a domestic corporation’s assets that produce gross FDDEI equal to the amount of such assets multiplied by the fraction that equals the amount of the domestic corporation’s deduction allowed under section 250(a)(1)(A) (taking into account the reduction under section 250(a)(2)(B)(i), if any) divided by its gross FDDEI. No portion of the value of stock in a foreign corporation is treated as an exempt asset by reason of this paragraph (d)(2)(ii)(C)(2)(i), including by reason of a transfer of intangible property to a foreign corporation subject to section 367(d) that gives rise to gross FDDEI.

(ii) *Controlled foreign corporation stock that gives rise to inclusions under section 951A(a).* The term “exempt asset” includes a portion of the value of a United States shareholder’s stock in a controlled foreign corporation if the United States shareholder is a domestic corporation that is eligible for a deduction under section 250(a) with respect to income described in section 250(a)(1)(B)(i) and all or a portion of the domestic corporation’s stock in the controlled foreign corporation is characterized as GILTI inclusion stock. The portion of foreign corporation stock that is treated as an exempt asset for a taxable year equals the portion of the value of such foreign corporation stock (determined in accordance with §§ 1.861-9(g), 1.861-12, and 1.861-13) that is characterized as GILTI inclusion stock multiplied by a fraction that equals the amount of the domestic corporation’s deduction allowed under section 250(a)(1)(B)(i) (taking into account the reduction under section 250(a)(2)(B)(ii), if any) divided by its GILTI inclusion amount (as defined in § 1.951A-1(c)(1) or, in the case of a member of a consolidated group, § 1.1502-51(b)) for such taxable year. The portion of controlled foreign corporation stock treated as an exempt asset under this paragraph (d)(2)(ii)(C)(2)(ii) is treated as attributable to the relevant categories of

GILTI inclusion stock described in each of paragraphs (d)(2)(ii)(C)(3)(i) through (v) of this section based on the relative value of the portion of the stock in each such category.

(3) *GILTI inclusion stock.* For purposes of paragraph (d)(2)(ii)(C)(2)(ii) of this section, the term *GILTI inclusion stock* means the aggregate of the portions of the value of controlled foreign corporation stock that are—

(i) Assigned to the section 951A category under § 1.861-13(a)(2);

(ii) Assigned to a particular treaty category under § 1.861-13(a)(3)(i) (relating to resourced gross tested income stock);

(iii) Assigned under § 1.861-13(a)(1) to the gross tested income statutory grouping within the foreign source passive category less the amount described in § 1.861-13(a)(5)(iii)(A);

(iv) Assigned under § 1.861-13(a)(1) to the gross tested income statutory grouping within the U.S. source general category less the amount described in § 1.861-13(a)(5)(iv)(A); and

(v) Assigned under § 1.861-13(a)(1) to the gross tested income statutory grouping within the U.S. source passive category less the amount described in § 1.861-13(a)(5)(iv)(B).

(4) *Non-applicability to section 250(b).* Paragraphs (d)(2)(ii)(C)(1) through (3) of this section do not apply when apportioning deductions for purposes of determining deduction eligible income or foreign-derived deduction eligible income under the operative section of section 250(b).

(5) *Example.* The following example illustrates the application of the rules in this paragraph (d)(2)(ii)(C).

(i) *Facts.* USP, a domestic corporation, directly owns all of the stock of CFC1 and CFC2, both of which are controlled foreign corporations. The tax book value of CFC1 and CFC2's stock is \$10,000x and \$9,000x, respectively. Pursuant to § 1.861-13(a), \$6,100x of the stock of CFC1 is assigned to the section 951A category under § 1.861-13(a)(2) ("section 951A category stock") and the remaining \$3,900x of the stock of CFC1 is assigned to the general category ("general category stock"). Additionally, \$4,880x of the stock of CFC2 is section 951A category stock and the remaining \$4,120x of the stock of CFC2

is general category stock. Under section 951A and the section 951A regulations (as defined in § 1.951A-1(a)(1)), USP's GILTI inclusion amount is \$610x. The portion of USP's deduction under section 250 described in section 250(a)(1)(B)(i) is \$305x. No portion of USP's deduction is reduced by reason of section 250(a)(2)(B)(ii).

(ii) *Analysis.* For purposes of apportioning deductions where section 904 is the operative section, under paragraph (d)(2)(ii)(C)(1) of this section, \$305x of USP's gross income attributable to its GILTI inclusion amount is exempt income. Under paragraph (d)(2)(ii)(C)(3) of this section, the GILTI inclusion stock of CFC1 is the \$6,100x of stock that is section 951A category stock and the GILTI inclusion stock of CFC2 is the \$4,880x of stock that is section 951A category stock. Under paragraph (d)(2)(ii)(C)(2) of this section, the portion of the value of the stock of CFC1 and CFC2 that is treated as an exempt asset equals the portion of the value of the stock of CFC1 and CFC2 that is GILTI inclusion stock multiplied by 50% (\$305x/\$610x). Accordingly, the exempt portion of the stock of CFC1 is \$3,050x (50% × \$6,100x) and the exempt portion of CFC2's stock is \$2,440x (50% × \$4,880x). Therefore, the stock of CFC1 taken into account for purposes of apportioning deductions is \$3,050x of non-exempt section 951A category stock and \$3,900x of general category stock. The stock of CFC2 taken into account for purposes of apportioning deductions is \$2,440x of non-exempt section 951A category stock and \$4,120x of general category stock.

(iii) *Income that is not considered tax exempt.* For further guidance, see § 1.861-8T(d)(2)(iii).

(A) For further guidance, see § 1.861-8T(d)(2)(iii)(A) and (B).

(B) [Reserved]

(C) Dividends for which a deduction is allowed under section 245A;

(D) Foreign earned income as defined in section 911 (however, the rules of § 1.911-6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)); and

(E) Inclusions for which a deduction is allowed under section 965(c). See § 1.965-6(c).

(iv) *Value of stock attributable to previously taxed earnings and profits.* No portion of the value of stock in a controlled foreign corporation is treated as an exempt asset by reason of the controlled foreign corporation having previously taxed earnings and profits. For example, no portion of the value of stock in a controlled foreign corporation is treated as an exempt asset by reason of the adjustment under § 1.861-12(c)(2) in respect of previously taxed earnings and profits described in section 959(c)(1) or (c)(2) (including earnings and profits described in section 959(c)(2) by reason of section 951A(f)(1) and § 1.951A-6(b)(1)). See also § 1.965-6(c).

(e) *Allocation and apportionment of certain deductions*—(1) *In general.* Paragraphs (e)(2) and (e)(3) of this section contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Paragraphs (e)(4) through (e)(8) of this section contain rules with respect to the allocation of certain other deductions. Paragraph (e)(9) of this section lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Paragraph (e)(10) of this section lists special deductions of corporations which must be allocated and apportioned. Paragraph (e)(11) of this section lists personal exemptions which are neither allocated nor apportioned. Paragraph (e)(12) of this section contains rules with respect to the allocation and apportionment of deductions for charitable contributions. Paragraphs (e)(13) and (14) of this section contain rules with respect to the allocation and apportionment of the deduction allowed under section 250(a). Paragraph (e)(15) of this section contains rules with respect to the allocation and apportionment of a taxpayer's distributive share of a partnership's deductions. Examples of allocation and apportionment are contained in paragraph (g) of this section.

(2) *Interest.* [Reserved]. For guidance, see § 1.861-8T(e)(2).

(3) *Research and experimental expenditures.* For rules regarding the allocation and apportionment of research and

experimental expenditures, see § 1.861-17.

(4) *Stewardship and controlled services*—(i) *Expenses attributable to controlled services.* If a corporation performs a controlled services transaction (as defined in § 1.482-9(1)(3)), which includes any activity by one member of a group of controlled taxpayers that results in a benefit to a related corporation, and the rendering corporation charges the related corporation for such services, section 482 and these regulations provide for an allocation where the charge is not consistent with an arm's length result as determined. The deductions for expenses of the corporation attributable to the controlled services transaction are considered definitely related to the amounts so charged and are to be allocated to such amounts.

(ii) *Stewardship expenses attributable to dividends received.* Stewardship expenses, which result from “overseeing” functions undertaken for a corporation's own benefit as an investor in a related corporation, shall be considered definitely related and allocable to dividends received, or to be received, from the related corporation. For purposes of this section, stewardship expenses of a corporation are those expenses resulting from “duplicative activities” (as defined in § 1.482-9(1)(3)(iii)) or “shareholder activities” (as defined in § 1.482-9(1)(3)(iv)) of the corporation with respect to the related corporation. Thus, for example, stewardship expenses include expenses of an activity the sole effect of which is either to protect the corporation's capital investment in the related corporation or to facilitate compliance by the corporation with reporting, legal, or regulatory requirements applicable specifically to the corporation, or both. If a corporation has a foreign or international department which exercises overseeing functions with respect to related foreign corporations and, in addition, the department performs other functions that generate other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign-source royalties, and gross income of foreign branches),

some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also generate United States source income (such as fees for services performed in the United States). Permissible methods of apportionment with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. See paragraph (f)(5) of this section for the type of verification that may be required in this respect. See § 1.482-9(1)(5) for examples that illustrate the principles of § 1.482-9(1)(3). See *Example 17* and *Example 18* of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. See paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship expenses, such as expenses in the nature of day-to-day management, and paragraph (e)(5) of this section generally for the allocation and apportionment of deductions attributable to legal and accounting fees and expenses.

(5) *Legal and accounting fees and expenses.* Fees and other expenses for legal and accounting services are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income, depending on the nature of the services rendered (and are apportioned as provided in paragraph (c)(1) of this section). For example, accounting fees for the preparation of a study of the costs involved in manufacturing a specific product will ordinarily be definitely related to the class of gross income derived from (or which could reasonably have been expected to be derived from) that specific product. The taxpayer is not relieved from his responsibility to make a proper allocation and apportionment of fees on the grounds that the statement of services rendered does not identify the services performed beyond a generalized designation such as

"professional," or does not provide any type of allocation, or does not properly allocate the fees involved.

(6) *Income taxes*—(i) *In general.* The deduction for foreign income, war profits and excess profits taxes allowed by section 164 (including with respect to a controlled foreign corporation) is allocated and apportioned among the applicable statutory and residual groupings under the principles of § 1.904-6(a)(1)(i), (ii), and (iv). The deduction for state and local taxes (*state income taxes*) allowed by section 164 is considered definitely related and allocable to the gross income with respect to which such state income taxes are imposed. For example, if a domestic corporation is subject to state income taxation and the state income tax is imposed in part on an amount of foreign source income, then that part of the taxpayer's deduction for state income tax that is attributable to foreign source income is definitely related and allocable to foreign source income. In allocating and apportioning the deduction for state income tax for purposes including (but not limited to) the computation of the foreign tax credit limitation under section 904 of the Code and the consolidated foreign tax credit under § 1.1502-4 of the regulations, the income upon which the state income tax is imposed is determined by reference to the law of the jurisdiction imposing the tax. Thus, if a state attributes taxable income to a corporate taxpayer by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the corporate taxpayer and engaging in activities related to the business of the corporate taxpayer, then the income so attributed is the income upon which the state income tax is imposed. If the income so attributed to the corporate taxpayer includes foreign source income, then, in computing the taxpayer's foreign tax credit limitation under section 904, for example, the taxpayer's deduction for state income tax will be considered definitely related and allocable to a class of gross income that includes the statutory grouping of foreign source income. When the law of the state includes dividends that are treated under section

862(a)(2) as income from sources without the United States in taxable income apportionable to the state, but does not include factors of the corporation paying such dividends in the apportionment formula used to determine state taxable income, an appropriate portion of the deduction for state income tax will be considered definitely related and allocable to a class of gross income consisting solely of foreign source dividend income. A deduction for state income tax will not be considered definitely related to a hypothetical amount of income calculated under federal tax principles when the jurisdiction imposing the tax computes taxable income under different principles. A corporate taxpayer's deduction for a state franchise tax that is computed on the basis of income attributable to business activities conducted within the state must be allocated and apportioned in the same manner as the deduction for state income taxes. In determining, for example, both the foreign tax credit under section 904 of the Code and the consolidated foreign tax credit limitation under §1.1502-4 of the regulations, the deduction for state income tax may be allocable and apportionable to foreign source income in a statutory grouping described in section 904(d) in a taxable year in which the taxpayer has no foreign source income in such statutory grouping. Alternatively, such an allocation or apportionment may be appropriate if a taxpayer corporation has no foreign source income in a statutory grouping, but its deduction is attributable to foreign source income in such grouping that is attributed to the taxpayer corporation under the law of a state which attributes taxable income to a corporation by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the taxpayer corporation and engaging in activities related to the business of the taxpayer corporation. Example 30 of paragraph (g) of this section illustrates the application of this last rule.

(ii) *Methods of allocation and apportionment*—(A) *In general.* A taxpayer's deduction for a state income tax is to be allocated (and then apportioned, if

necessary, subject to the rules of §1.861-8(d)) by reference to the taxable income that the law of the taxing jurisdiction attributes to the taxpayer ("state taxable income").

(B) *Effect of subsequent recomputations of state income tax.* [Reserved]

(C) *Illustrations*—(1) *In general.* Examples 25 through 32 of paragraph (g) of §1.861-8 illustrate, in the given factual situations, the application of this paragraph (e)(6) and the general rule of paragraph (b)(1) of this section that a deduction must be allocated to the class of gross income to which the deduction is factually related. In general, these examples employ a presumption that state income taxes are allocable to a class of gross income that includes the statutory grouping of income from sources without the United States when the total amount of taxable income determined under state law exceeds the amount of taxable income determined under the Code (without taking into account the deduction for state income taxes) in the residual grouping of income from sources within the United States. A taxpayer that allocates and apportions the deduction for state income tax in accordance with the methodology of Example 25 of paragraph (g) of this section must also apply the modifications illustrated in Examples 26 and 27 of paragraph (g) of this section, when applicable. The modification illustrated in *Example 26* is applicable when the deduction for state income tax is attributable in part to taxes imposed by a state which factually excludes foreign source income (as determined for federal income tax purposes) from state taxable income. The modification illustrated in *Example 27* is applicable when the taxpayer has income-producing activities in a state which does not impose a corporate income tax. The specific allocation of state income tax illustrated in *Example 28* follows the rule in paragraph (e)(6)(i) of this section, and must be applied whenever a taxpayer's state taxable income includes dividends apportioned to the state under a formula that does not take into account the factors of the corporations paying those dividends, regardless of whether the taxpayer uses the methodology of

Example 25 with respect to the remainder of the deduction for state income taxes.

(2) *Modifications.* Before applying a method of allocation and apportionment illustrated in the examples, the computation of state taxable income under state law may be modified, subject to the approval of the District Director, to reflect more accurately the income with respect to which the state income tax is imposed. Any modification to the state law computation of state taxable income must yield an allocation and apportionment of the deduction for state income taxes that is consistent with the rules contained in this paragraph (e)(6), and that accurately reflects the factual relationship between the state income tax and the income on which that tax is imposed. For example, a modification to the computation of taxable income under state law might be appropriate to compensate for differences between the state law definition of taxable income and the federal definition of taxable income, due to a difference in the rate of allowable depreciation or the amount of another deduction that is allowable under both systems. This rule is illustrated in Example 31 of paragraph (g) of this section. However, a modification to the computation of taxable income under state law will not be appropriate, and will not more accurately reflect the factual relationship between the state tax and the income on which the tax is imposed, to the extent such modification reflects the fact that the state does not follow federal tax principles in attributing income to the taxpayer's activities in the state. This rule is illustrated in Example 32 of paragraph (g) of this section. A taxpayer may not modify the methods illustrated in the examples, or use an alternative method of allocation and apportionment of the deduction for state income taxes, if the modification or alternative method would be inconsistent with the rules of paragraph (e)(6)(i) of this section. A taxpayer that uses a method of allocation and apportionment other than one illustrated in Example 25 (as modified by Examples 26 and 27), or 29 with respect to a factual situation similar to those of the examples, must describe the alter-

native method on an attachment to its federal income tax return and establish to the satisfaction of the District Director, upon examination, that the result of the alternative method more accurately reflects the factual relationship between the state income tax and the income on which the tax is imposed.

(D) *Elective safe harbor methods*—(1) *In general.* In lieu of applying the rules set forth in paragraphs (e)(6)(ii)(A) through (C) of this section, a taxpayer may elect to allocate and apportion the deduction for state income tax in accordance with one of the two safe harbor methods described in paragraph (e)(6)(ii)(D)(2) and (3) of this section. A taxpayer shall make this election for a taxable year by filing a timely tax return for that year that reflects an allocation and apportionment of the deduction for state income tax under one of the safe harbor methods and attaching to such return a statement that the taxpayer has elected to use the safe harbor method provided in either paragraph (e)(6)(ii)(D)(2) or (3) of this section, as appropriate. Once made, this election is effective for the taxable year for which made and all subsequent taxable years, and may be revoked only with the consent of the Commissioner. Example 33 of paragraph (g) of this section illustrates the application of these safe harbor methods.

(2) *Method One*—(i) *Step One—Specific allocation to foreign source portfolio dividends and other income.* If any portion of the deduction for state income tax is attributable to tax imposed by a state which includes in a corporate taxpayer's taxable income apportionable to the state, portfolio dividends (as defined in paragraph (i) of Example 28 of paragraph (g) of this section) that are treated under section 862(a)(2) as income from sources without the United States, but does not include factors of the corporations paying the portfolio dividends in the apportionment formula used to determine state taxable income, the taxpayer shall allocate an appropriate portion of the deduction to a class of gross income consisting solely of foreign source portfolio dividends. The portion of the deduction so allocated, and the amount of foreign source portfolio dividends included in

such class, shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 28 of paragraph (g). If a state income tax is determined based upon formulary apportionment of the total taxable income attributable to the taxpayer's unitary business, the taxpayer must also apply the methodology illustrated in paragraph (ii)(C) through (G) of Example 29 of paragraph (g) of this section to make specific allocations of appropriate portions of the deduction for state income tax on the basis of income that, under separate accounting, would have been attributed to other members of the unitary group. The taxpayer shall reduce its aggregate state taxable income by the amount of foreign source portfolio dividends and other income to which a specific allocation is made (the reduced amount being referred to hereinafter as "adjusted state taxable income").

(ii) *Step Two—Adjustment of U.S. source federal taxable income.* If the taxpayer has significant income-producing activities in a state which does not impose a corporate income tax or other state tax measured by income derived from business activities in the state, the taxpayer shall reduce its U.S. source federal taxable income (solely for purposes of this safe harbor method) by the amount of federal taxable income attributable to its activities in such state. This amount shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 27 of paragraph (g) of this section, provided that the taxpayer shall be required to use the rules of the Uniform Division of Income for Tax Purposes Act to attribute income to the relevant state. The taxpayer's U.S. source federal taxable income, as so reduced, is referred to hereinafter as "adjusted U.S. source federal taxable income."

(iii) *Step Three—Allocation.* The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall sub-

stitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to an amount equal to 110% of its adjusted U.S. source federal taxable income.

(iv) *Step Four—Apportionment.* In the event that apportionment of the remainder of the deduction for state income tax is required, the taxpayer shall apportion that remaining deduction to U.S. source income in accordance with the methodology illustrated in paragraph (iii) of Example 25 of paragraph (g) of this section, substituting for domestic source income in that paragraph an amount equal to 110% of the taxpayer's adjusted U.S. source federal taxable income. The remaining portion of the deduction shall be apportioned to the statutory groupings of foreign source income described in section 904(d) of the Code in accordance with the proportion of the income in each statutory grouping of foreign source income described in section 904(d) to the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above).

(3) *Method Two—(i) Step One—Specific allocation to foreign source portfolio dividends and other income.* Step One of this method is the same as Step One of Method One (as described in paragraph (e)(6)(ii)(D)(2)(i) of this section).

(ii) *Step Two—Adjustment of U.S. source federal taxable income.* Step Two of this method is the same as Step Two of Method One (as described in paragraph (e)(6)(ii)(D)(2)(ii) of this section).

(iii) *Step Three—Allocation.* The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in

paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to its adjusted U.S. source federal taxable income.

(iv) *Step Four—Apportionment.* In the event that apportionment of the deduction is required, the taxpayer shall apportion to U.S. source income that portion of the deduction that is attributable to state income taxes imposed upon an amount of state taxable income equal to adjusted U.S. source federal taxable income. The taxpayer shall apportion the remaining amount of the deduction to U.S. and foreign source income in the same proportions that the taxpayer's adjusted U.S. source federal taxable income and foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) bear to its total federal taxable income (taking into account the adjustment of U.S. source federal taxable income under Step Two and after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One). The portion of the deduction apportioned to foreign source income shall be apportioned among the statutory groupings described in section 904(d) of the Code in accordance with the proportions of the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) in each grouping.

(7) *Losses on the sale, exchange, or other disposition of property—(i) Allocation.* The deduction allowed for loss recognized on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) shall be considered a deduction which is definitely related and allocable to the class of gross income to which such asset or property ordinarily gives rise in the hands of the taxpayer. Where the nature of gross income generated from the asset or property has varied significantly over several taxable years of the taxpayer, such class of gross income shall generally be determined by reference to gross income generated from

the asset or property during the taxable year or years immediately preceding the sale, exchange, or other disposition of such asset or property. Thus, for example, where an asset generates primarily sales income from domestic sources in the early years of its operation and then is leased by the taxpayer to a foreign subsidiary in later years, the class of gross income to which the asset gives rise will be considered to be the rental income derived from the lease and will not include sales income from domestic sources.

(ii) *Apportionment of losses.* Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) is necessary, the amount of such deduction shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income (within the class of gross income) and the residual grouping (within the class of gross income) in the same proportion that the amount of gross income within such statutory grouping (or statutory groupings) and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. Apportionment will be necessary where, for example, the class of gross income to which the deduction is allocated consists of gross income (such as royalties) attributable to an intangible asset used both within and without the United States, or gross income (such as from sales or services) attributable to a tangible asset used both within and without the United States.

(iii) *Allocation of loss recognized in taxable years after 1986.* See §§ 1.865-1 and 1.865-2 for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) *Net operating loss deduction.* A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

(9) *Deductions which are not definitely related.* Deductions which shall generally be considered as not definitely

related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(3) of this section, are—

(i) The deduction allowed by section 163 for interest described in subparagraph (2)(iii) of this paragraph (e);

(ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;

(iii) The deduction for medical expenses allowed by section 213; and

(iv) The deduction for alimony payments allowed by section 215.

(10) [Reserved]

(11) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151, 642(b), or 873(b)(3) shall not be taken into account for purpose of allocation and apportionment under this section.

(12) *Deductions for certain charitable contributions—(i) In general.* The deduction for charitable contributions that is allowed under sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(i) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping.

(ii) *Treaty provisions.* If a deduction for charitable contributions not otherwise permitted by sections 170, 873(b)(2), and 882(c)(1)(B) is allowed under a U.S. income tax treaty, and such treaty limits the amount of the deduction based on a percentage of income arising from sources within the treaty partner, the deduction is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(ii) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources within the treaty partner within each grouping.

(iii) *Coordination with §§ 1.861-14 and 1.861-14T.* A deduction for a charitable contribution by a member of an affiliated group shall be allocated and ap-

portioned under the rules of this section, § 1.861-14(e)(6), and § 1.861-14T(c)(1).

(13) *Foreign-derived intangible income.* The portion of the deduction that is allowed for foreign-derived intangible income under section 250(a)(1)(A) (taking into account the reduction under section 250(a)(2)(B)(i), if any) is considered definitely related and allocable to the class of gross income included in the taxpayer's foreign-derived deduction eligible income (as defined in section 250(b)(4)). If necessary, the portion of the deduction is apportioned within the class ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income based on the relative amounts of foreign-derived deduction eligible income in each grouping.

(14) *Global intangible low-taxed income and related section 78 gross up.* The portion of the deduction (taking into account the reduction under section 250(a)(2)(B)(ii), if any) that is allowed for the global intangible low-taxed income amount described in section 250(a)(1)(B)(i), and that is allowed for the section 78 gross up under section 250(a)(1)(B)(ii), is considered definitely related and allocable to the class of gross income included under section 951A(a) and section 78, respectively. If necessary (for example, because a portion of the inclusion under section 951A(a) is passive category income or U.S. source income), the portion of the deduction is apportioned within the class ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income based on the relative amounts of gross income in each grouping.

(15) *Distributive share of partnership deductions.* In general, if deductions are incurred by a partnership in which the taxpayer is a partner, the taxpayer's deductions that are allocated and apportioned include the taxpayer's distributive share of the partnership's deductions. See §§ 1.861-9(e), 1.861-17(f), and 1.904-4(n)(1)(ii) for special rules for apportioning a partner's distributive share of deductions of a partnership.

(f) *Miscellaneous matters—(1) Operative sections.* The operative sections of the

Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.

(i) [Reserved]

(ii) *Separate foreign tax credit limitations.* Section 904(d)(1) and other sections described in § 1.904-4(m) require that a separate foreign tax credit limitation be determined with respect to each separate category of income specified in those sections. Accordingly, the foreign source income within each separate category described in § 1.904-5(a)(4)(v) constitutes a separate statutory grouping of income. U.S. source income is treated as income in the residual grouping for purposes of determining the limitation on the foreign tax credit.

(iii) *DISC and FSC taxable income.* Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC, respectively, with respect to qualified sales and leases of export property and qualified services. The combined taxable income method available for determining a DISC's taxable income provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from sales and leases of export property and from services. In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under section 925 and 994, this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under sections 925(b)(2) and 994(b)(2) if used by the taxpayer. See *Examples* (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of the section 925(d) limitation and the "no loss" rules of the regulations under sections 925 and 994.

(iv) *Effectively connected taxable income.* Nonresident alien individuals and

foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Such taxable income is determined in most instances by initially determining, under section 864(c), the amount of gross income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to sections 873 and 882(c), this section is applicable for purposes of determining the deductions from such gross income (other than the deduction for interest expense allowed to foreign corporations (see § 1.882-5)) which are to be taken into account in determining taxable income. See example 21 of paragraph (g) of this section.

(v) *Foreign base company income.* Section 954 defines the term "foreign base company income" with respect to controlled foreign corporations. Section 954(b)(5) provides that in determining foreign base company income the gross income shall be reduced by the deductions of the controlled foreign corporation "properly allocable to such income". This section provides rules for identifying which deductions are properly allocable to foreign base company income.

(vi) *Other operative sections.* The rules provided in this section also apply in determining—

(A) The amount of foreign source items of tax preference under section 58(g) determined for purposes of the minimum tax;

(B) The amount of foreign mineral income under section 901(e);

(C) [Reserved]

(D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;

(E) The tax base for individuals entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation that has an election in effect under section 936;

(F) The exclusion for income from Puerto Rico for bona fide residents of Puerto Rico under section 933;

(G) The limitation under section 934 on the maximum reduction in income

tax liability incurred to the Virgin Islands;

(H) The income derived from the U.S. Virgin Islands or from a section 935 possession (as defined in § 1.935-1(a)(3)(i)).

(I) The special deduction granted to China Trade Act corporations under section 941;

(J) The amount of certain U.S. source income excluded from the subpart F income of a controlled foreign corporation under section 952(b);

(K) The insurance of U.S. risks under section 953(b)(5);

(L) The international boycott factor and the specifically attributable taxes and income under section 999; and

(M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936, as amended, and the Capital Construction Fund Regulations thereunder (26 CFR, part 3). See 26 CFR 3.2(b)(3).

(2) *Application to more than one operative section.* (i) Where more than one operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

(ii) When expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or former DISC and residual gross income, regardless of which of the administrative pricing methods of section 994 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the DISC or former DISC attributable to income of the DISC or former DISC as determined under the administrative pricing methods with respect to DISC or former DISC taxable years beginning after December 31, 1986. Accordingly, *Example (22)* of paragraph (g) of this section does not apply to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years beginning after December 31, 1986. This rule does not apply to the ex-

tent that the taxable income of the DISC or former DISC is determined under the section 994(a)(3) transfer pricing method. In addition, for taxable years beginning after December 31, 1986, in the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a FSC and residual gross income, regardless of which of the administrative pricing methods of section 925 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the FSC or former FSC which are attributable to the foreign trade income of the FSC or former FSC as determined under the administrative pricing methods. This rule does not apply to the extent that the foreign trade income of the FSC or former FSC is determined under the section 925(a)(3) transfer pricing method. See *Example (23)* of paragraph (g) of this section.

(3) *Special rules of section 863(b)*—(i) *In general.* Special rules under section 863(b) provide for the application of rules of general apportionment provided in §§ 1.863-3 to 1.863-5, to worldwide taxable income in order to attribute part of such worldwide taxable income to U.S. sources and the remainder of such worldwide taxable income to foreign sources. The activities specified in section 863(b) are—

(A) Transportation or other services rendered partly within and partly without the United States,

(B) Sales of personal property produced by the taxpayer within and sold without the United States, or produced by the taxpayer without and sold within the United States, and

(C) Sales within the United States of personal property purchased within a possession of the United States.

In the instances provided in §§ 1.863-3 and 1.863-4 with respect to the activities described in (A), (B), and (C) of this subdivision, this section is applicable only in determining worldwide taxable income attributable to these activities.

(ii) *Relationship of sections 861, 862, 863(a), and 863(b).* Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources. Each of

these four provisions applies independently. Where a deduction has been allocated and apportioned to income under one of these four provisions, the deduction shall not again be allocated and apportioned to gross income under any of the other three provisions. However, two or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction. The special rules under section 863(b) take precedence over the general rules of Code sections 861, 862 and 863(a). For example, where a deduction is allocable in whole or in part to gross income to which section 863(b) applies, such deduction or part thereof shall not otherwise be allocated under section 861, 862, or 863(a). However, where the gross income to which the deduction is allocable includes both gross income to which section 863(b) applies and gross income to which section 861, 862, or 863(a) applies, more than one section must be applied at the same time in order to determine the proper allocation and apportionment of the deduction.

(4) *Adjustments made under other provisions of the Code*—(i) *In general.* If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this section in order to reflect changes resulting from the adjustment. The recomputation made by the Commissioner shall be made using the same method of allocation and apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(2) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer's income and deductions which would not otherwise be made may be required before applying this section in order to prevent a dis-

tortion in determining taxable income from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the Commissioner to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent corporation continues to incur expenses in connection with protecting its capital investment in the foreign subsidiaries (see paragraph (e)(4) of this section), it may be necessary for the Commissioner to make an allocation under section 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(ii) *Example*—(A) *Facts.* USP, a domestic corporation, purchases and sells consumer items in the United States and foreign markets. Its sales in foreign markets are made to related foreign subsidiaries. USP reported \$1,500,000x as sales during the taxable year of which \$1,000,000x was domestic sales and \$500,000x was foreign sales. USP took a deduction for expenses incurred by its marketing department during the taxable year in the amount of \$150,000x. These expenses were determined to be allocable to both domestic and foreign sales and are apportionable between such sales. On audit of USP's return for the taxable year, the IRS adjusted, under section 482, USP's sales to related foreign subsidiaries by increasing the sales price by a total of \$100,000x, thereby increasing USP's foreign sales and total sales by the same amount. Before the audit, USP allocated and apportioned the marketing department deduction as follows:

TABLE 1 TO PARAGRAPH (f)(4)(ii)(A)

To gross income from domestic sales: \$150,000x × (\$1,000,000x/\$1,500,000x)	\$100,000x
To gross income from foreign sales: \$150,000x × (\$500,000x/\$1,500,000x)	50,000x

TABLE 1 TO PARAGRAPH (f)(4)(ii)(A)—Continued

Total	150,000x
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(B) *Analysis.* As a result of the section 482 adjustment, the apportionment of the deduction for the marketing department expenses is redetermined as follows:

TABLE 2 TO PARAGRAPH (f)(4)(ii)(B)

To gross income from domestic sales: $\$150,000x \times (\$1,000,000x/\$1,600,000x)$	\$93,750x
To gross income from foreign sales: $\$150,000x \times (\$600,000x/\$1,600,000x)$	56,250x
Total	150,000x

(5) *Verification of allocations and apportionments.* Since, under this section, allocations and apportionments are made on the basis of the factual relationship between deductions and gross income, the taxpayer is required to furnish, at the request of the District Director, information from which such factual relationships can be determined. In reviewing the overall limitation to the foreign tax credit of a domestic corporation, for example, the District Director should consider information which would enable him to determine the extent to which deductions attributable to functions performed in the United States are related to earning foreign source income, United States source income, or income from both sources. In addition to functions with a specific international purpose, consideration should be given to the functions of management, the direction and results of an acquisition program, the functions of operating units and personnel located at the head office, the functions of support units (including but not limited to engineering, legal, budget, accounting, and industrial relations), the functions of selling and advertising units and personnel, the direction and uses of research and development and the direction and uses of services furnished by independent contractors. Thus, for example when requested by the District Director, the taxpayer shall make available any of its organization charts, manuals, and other writings which relate to the manner in which its gross income

arises and to the functions of organizational units, employees, and assets of the taxpayer and arrange for the interview of such of its employees as the District Director deems desirable in order to determine the gross income to which deductions relate. See section 7602 and the regulations thereunder which generally provide for the examination of books and witnesses. See also section 905(b) and the regulations thereunder which require proof of foreign tax credits to the satisfaction of the Secretary or his delegate.

(g) *Examples.* The following examples illustrate the principles of the rules in this section. In each example, unless otherwise specified, section 904 is the operative section. In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayers on a consistent basis from year to year. Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis.

(1)–(18) [Reserved]

(19) *Example 19: Supportive expense—(i) Facts—*(A) USP, a domestic corporation, purchases and sells products both in the United States and in foreign countries. USP has no foreign subsidiary and no international department. During the taxable year, USP incurs the following expenses with respect to its worldwide activities:

TABLE 3 TO PARAGRAPH (g)(19)(i)(A)

Personnel department expenses	\$50,000x
Training department expenses	35,000x
General and administrative expenses	55,000x
President's salary	40,000x
Sales manager's salary	20,000x
Total	200,000x

(B) USP has domestic gross receipts from sales of \$750,000x and foreign gross receipts from sales of \$500,000x and has gross income from such sales in the same ratio, namely \$300,000x from domestic sources and \$200,000x from foreign sources that is general category income.

(ii) *Analysis—(A) Allocation.* The above expenses are definitely related and allocable to all of USP's gross income derived from both domestic and foreign markets.

(B) *Apportionment.* For purposes of applying the foreign tax credit limitation, the statutory grouping is gross income from sources outside the United States in general category income and the residual grouping is gross income from sources within the United States. USP's deductions for its worldwide sales activities must be apportioned between these groupings. USP

does not have a separate international division which performs essentially all of the functions required to manage and oversee its foreign activities. The president and sales manager do not maintain time records. The division of their time between domestic and foreign activities varies from day to day and cannot be estimated on an annual basis with any reasonable degree of accuracy. Similarly, there are no facts which would justify a method of apportionment of their salaries or of one of the other listed deductions based on more specific factors than gross receipts or gross income. An acceptable method of apportionment would be on the basis of gross receipts. The apportionment of the \$200,000x deduction is as follows:

TABLE 4 TO PARAGRAPH (g)(19)(ii)(B)

Apportionment of the \$200,000x expense to the statutory grouping of gross income: $\$200,000x \times [\$500,000x / (\$500,000x + \$750,000x)]$	\$80,000x
Apportionment of the \$200,000x expense to the residual grouping of gross income: $\$200,000x \times [\$750,000x / (\$500,000x + \$750,000x)]$	120,000x
Total apportioned supportive expense	200,000x

(20) *Example 20: Supportive expense—(i) Facts.* Assume the same facts as in paragraph (g)(19)(i) of this section (the facts in *Example 19*), except that USP's president devotes only 5% of his time to the foreign operations and 95% of his time to the domestic operations and that USP's sales manager devotes approximately 10% of her time to foreign sales and 90% of her time to domestic sales.

(ii) *Analysis—(A) Allocation.* The expenses incurred by USP with respect to its worldwide activities are definitely

related, and therefore allocable to USP's gross income from both its foreign and domestic markets.

(B) *Apportionment.* On the basis of the additional facts it is not acceptable to apportion the salaries of the president and the sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory grouping (gross income from sources without the United States) and residual grouping (gross income from sources within the United States) on the basis of time devoted to each sales

activity. Remaining expenses may still be apportioned on the basis of gross receipts. The apportionment is as follows:

TABLE 5 TO PARAGRAPH (g)(20)(ii)(B)

Apportionment of the \$200,000x expense to the statutory grouping of gross income:	
President's salary: $\$40,000x \times 5\%$	\$2,000x
Sales manager's salary: $\$20,000x \times 10\%$	2,000x
Remaining expenses: $\$140,000x \times [\$500,000x/(\$500,000x + \$750,000x)]$	56,000x
Subtotal: Apportionment of expense to statutory grouping	60,000x
Apportionment of the \$200,000x expense to the residual grouping of gross income:	
President's salary: $\$40,000x \times 95\%$	38,000x
Sales manager's salary: $\$20,000x \times 90\%$	18,000x
Remaining expenses: $\$140,000x \times [\$750,000x/(\$500,000x + \$750,000x)]$	84,000x
Subtotal: Apportionment of expense to residual grouping	140,000x
Total: Apportioned supportive expense	200,000x

(21) *Example 21: Supportive expense*—(i) *Facts.* FC, a foreign corporation doing business in the United States, is a manufacturer of metal stamping machines. FC has no U.S. subsidiaries and no separate division to manage and oversee its business in the United States. FC manufactures and sells these machines in the United States and in foreign countries A and B and has a separate manufacturing facility in each country. Sales of these machines are FC's only source of income. In Year 1, FC incurs general and administrative expenses related to both its U.S. and foreign operations of \$100,000x. It has machine sales of \$500,000x, \$1,000,000x, and \$1,000,000x on which it earns gross income of \$200,000x, \$400,000x, and \$400,000x in the United States, Country A, and Country B, respectively. The income from the manufacture and sale of the machines in countries A and B is not effectively connected with FC's business in the United States.

(ii) *Analysis*—(A) *Allocation.* The \$100,000x of general and administrative

expense is definitely related to the income to which it gives rise, namely a part of the gross income from sales of machines in the United States, in Country A, and in Country B. The expenses are allocable to this class of income, even though FC's gross income from sources outside the United States is excluded income since it is not effectively connected with a U.S. trade or business.

(B) *Apportionment.* Since FC is a foreign corporation, the statutory grouping is gross income effectively connected with FC's trade of business in the United States, namely gross income from sources within the United States, and the residual grouping is gross income not effectively connected with a trade or business in the United States, namely gross income from countries A and B. Since there are no facts that would require a method of apportionment other than on the basis of sales or gross income, the amount may be apportioned between the two groupings on the basis of amounts of gross income as follows:

TABLE 6 TO PARAGRAPH (g)(21)(ii)(B)

Apportionment of general and administrative expense to the statutory grouping, gross income from sources within the United States: $\$100,000x \times [\$200,000x/(\$200,000x + \$400,000x + \$400,000x)]$	\$20,000x
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TABLE 6 TO PARAGRAPH (g)(21)(ii)(B)—Continued

Apportionment of general and administrative expense to the residual grouping, gross income from sources without the United States: $\$100,000x \times [(\$400,000x + \$400,000x)/(\$200,000x + \$400,000x + \$400,000x)]$	80,000x
Total apportioned general and administrative expense	100,000x

(22)–(24) [Reserved]

(25) *Example 25: Income taxes*—(i) *Facts.* USP, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states A, B, and C. USP also has a foreign branch, as defined in section 904(d)(1)(B) and §1.904-4(f), in Country Y which manufactures and distributes the same type of electronic equipment. In Year 1, USP has taxable income from these activities, as described under the Code (without taking into account the deduction for state income taxes), of \$1,000,000x, of which \$200,000x is foreign source foreign branch category income and \$800,000x is domestic source income. States A, B, and C each determine USP's income subject to tax within their state by making adjustments to USP's taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of the relative amounts of USP's payroll, property, and sales within each state as compared to USP's worldwide payroll, property, and sales. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income as determined under the Code. On this basis, it is determined that USP has taxable income of \$550,000x, \$200,000x, and \$200,000x in states A, B, and C, respectively. The corporate tax rates in states A, B, and C are 10%, 5%, and 2%, respectively, and USP has total state income tax li-

abilities of \$69,000x (\$55,000x + \$10,000x + \$4,000x), which it deducts as an expense for Federal income tax purposes.

(ii) *Analysis*—(A) *Allocation.* USP's deduction of \$69,000x for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since the statutes of states A, B, and C do not specifically exempt foreign source income (as determined under the Code) from taxation and since, in the aggregate, states A, B, and C tax \$950,000x of USP's income while only \$800,000x is domestic source income under the Code, it is presumed that state income taxes are imposed on \$150,000x of foreign source income. The deduction for state income taxes is therefore related and allocable to both USP's foreign source and domestic source income.

(B) *Apportionment.* For purposes of computing the foreign tax credit limitation, USP's income is comprised of one statutory grouping, foreign source foreign branch category gross income, and one residual grouping, gross income from sources within the United States. The state income tax deduction of \$69,000x must be apportioned between these two groupings. Corporation USP calculates the apportionment on the basis of the relative amounts of foreign source foreign branch category taxable income and U.S. source taxable income subject to state taxation. In this case, state income taxes are presumed to be imposed on \$800,000x of domestic source income and \$150,000x of foreign source general category income.

TABLE 7 TO PARAGRAPH (g)(25)(ii)(B)

State income tax deduction apportioned to foreign source foreign branch category income (statutory grouping): $\$69,000x \times (\$150,000x/\$950,000x)$	\$10,895x
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TABLE 7 TO PARAGRAPH (g)(25)(ii)(B)—Continued

State income tax deduction apportioned to income from sources within the United States (residual grouping): $\$69,000x \times (\$800,000x/\$950,000x)$	58,105x
Total apportioned state income tax deduction	69,000x

(26) *Example 26: Income taxes*—(i) *Facts.* Assume the same facts as in paragraph (g)(25)(i) of this section (the facts in *Example 25*), except that the language of state A's statute and the statute's operation exempt from taxation all foreign source income, as determined under the Code, so that foreign source income is not included in adjusted taxable income subject to apportionment in state A (and factors relating to USP's Country Y branch are not taken into account in computing the state A apportionment fraction).

(ii) *Analysis*—(A) *Allocation.* USP's deduction of \$69,000x for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by statute, state A is presumed to impose tax on \$550,000x of USP's \$800,000x of domestic source income. USP's state A tax of \$55,000x is allocable, therefore, solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as de-

termined under the Code, and since states B and C impose tax on \$400,000x (\$200,000x + \$200,000x) of USP's income of which only \$250,000x (\$800,000x - \$550,000x) is presumed to be domestic source, the deduction for the \$14,000x of income taxes imposed by states B and C is related and allocable to both foreign source and domestic source income.

(B) *Apportionment*—(1) For purposes of computing the foreign tax credit limitation, USP's income is comprised of one statutory grouping, foreign source foreign branch category gross income, and one residual grouping, gross income from sources within the United States. The deduction of \$14,000x for income taxes of states B and C must be apportioned between these two groupings.

(2) Corporation USP calculates the apportionment on the basis of the relative amounts of foreign source foreign branch category income and U.S. source income subject to state taxation.

TABLE 8 TO PARAGRAPH (g)(26)(ii)(B)(2)

States B and C income tax deduction apportioned to foreign source foreign branch category income (statutory grouping): $\$14,000x \times (\$150,000x/\$400,000x)$	\$5,250x
States B and C income tax deduction apportioned to income from sources within the United States (residual grouping): $\$14,000x \times (\$250,000x/\$400,000x)$	8,750x
Total apportioned state income tax deduction	14,000x

(3) Of USP's total income taxes of \$69,000x, the amount allocated and apportioned to foreign source foreign branch category income equals \$5,250x. The total amount of state income taxes allocated and apportioned to U.S. source income equals \$63,750x (\$55,000x + \$8,750x).

(27) *Example 27: Income tax*—(i) *Facts.* Assume the same facts as in paragraph

(g)(25)(i) of this section (the facts in *Example 25*), except that state A, in which USP has significant income-producing activities, does not impose a corporate income tax or other state tax computed on the basis of income derived from business activities conducted in state A. USP therefore has a total state income tax liability in Year 1 of \$14,000x (\$10,000x paid to state B

plus \$4,000x paid to state C), all of which is subject to allocation and apportionment under paragraph (b) of this section.

(ii) *Analysis*—(A) *Allocation*—(1) USP's deduction of \$14,000x for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. However, in these facts, an adjustment is necessary before the aggregate state taxable incomes can be compared with U.S. source income on the Federal income tax return in the manner described in paragraphs (g)(25)(ii) and (g)(26)(ii) of this section (the analysis in *Examples 25* and *26*). Unlike the facts in paragraphs (g)(25)(i) and (g)(26)(i) of this section (the facts in *Examples 25* and *26*), state A imposes no income tax and does not define taxable income attributable to activities in state A. The total amount of USP's income subject to state taxation is, therefore, \$400,000x (\$200,000x in state B and \$200,000x in state C). This total presumptively does not include any income attributable to activities performed in state A and therefore cannot properly be compared to total U.S. source taxable income reported by USP for Federal income tax purposes, which does include income attributable to state A activities.

(2)(i) Accordingly, before applying the method used in paragraphs (g)(25)(ii) and (g)(26)(ii) of this section (the analysis in *Examples 25* and *26*) to the facts of the example in this paragraph (g)(27), it is necessary first to estimate the amount of taxable income that state A could reasonably attribute to USP's activities in state A, and then to reduce federal taxable income by that amount.

(ii) Any reasonable method may be used to attribute taxable income to USP's activities in state A. For example, the rules of the Uniform Division of Income for Tax Purposes Act ("UDITPA") attribute income to a state on the basis of the average of three ratios that are based upon the taxpayer's facts—property within the state over total property, payroll within the state over total payroll, and sales within the state over total sales—and, with adjustments, provide a reasonable method for this purpose. When applying the rules of UDITPA to esti-

mate U.S. source income derived from state A activities, the taxpayer's UDITPA factors must be adjusted to eliminate both taxable income and factors attributable to a foreign branch. Therefore, in the example in this paragraph (g)(27) all taxable income as well as UDITPA apportionment factors (property, payroll, and sales) attributable to USP's Country Y branch must be eliminated.

(3)(i) Since it is presumed that, if state A had had an income tax, state A would not attempt to tax the income derived by USP's Country Y branch, any reasonable estimate of the income that would be taxed by state A must exclude any foreign source income.

(ii) When using the rules of UDITPA to estimate the income that would have been taxable by state A in these facts, foreign source income is excluded by starting with federally defined taxable income (before deduction for state income taxes) and subtracting any income derived by USP's Country Y branch. The hypothetical state A taxable income is then determined by multiplying the resulting difference by the average of USP's state A property, payroll, and sales ratios, determined using the principles of UDITPA (after adjustment by eliminating the Country Y branch factors). The resulting product is presumed to be exclusively U.S. source income, and the allocation and apportionment method described in paragraph (g)(26) of this section (*Example 26*) must then be applied.

(iii) If, for example, state A taxable income were determined to equal \$550,000x, then \$550,000x of U.S. source income for Federal income tax purposes would be presumed to constitute state A taxable income. Under paragraph (g)(26) of this section (*Example 26*), the remaining \$250,000x (\$800,000x - \$550,000x) of U.S. source income for Federal income tax purposes would be presumed to be subject to tax in states B and C. Since states B and C impose tax on \$400,000x, the application of *Example 25* would result in a presumption that \$150,000x is foreign source income and \$250,000x is domestic source income. The deduction for the \$14,000x of income taxes of states B and

C would therefore be related and allocable to both foreign source and domestic source income and would be subject to apportionment.

(B) *Apportionment.* The deduction of \$14,000x for income taxes of states B and C is apportioned in the same manner as in paragraph (g)(26) of this section (*Example 26*). As a result, \$5,250x of the \$14,000x of state B and state C income taxes is apportioned to foreign source foreign branch category income ($\$14,000x \times \$150,000x/\$400,000x$), and \$8,750x ($\$14,000x \times \$250,000x/\$400,000x$) of the \$14,000x of state B and state C income taxes is apportioned to U.S. source income.

(h) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

[T.D. 7456, 42 FR 1195, Jan. 6, 1977]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.861-8, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at www.govinfo.gov.

§ 1.861-8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

(a) *In general.* (1) [Reserved]

(2) *Allocation and apportionment of deductions in general.* If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income, except to the extent that expenses, losses, and other deductions are allocated and apportioned as if all domestic members of an affiliated group were a single corporation under section 864(e) and the regulations thereunder. See § 1.861-9T through § 1.861-11T for rules regarding the affiliated group allocation and apportionment of interest expense, and § 1.861-14T for rules regarding the affiliated group allocation and apportionment of expenses other than interest.

(a)(3)-(b) [Reserved] For further guidance, see § 1.861-8(a)(3) through (b).

(c) *Apportionment of deductions—(1) Deductions definitely related to a class of gross income.* Where a deduction has

been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. Thus, in determining the separate limitations on the foreign tax credit imposed by section 904(d)(1) or by section 907, the income within a separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual grouping. In this regard, the same method of apportionment must be used in apportioning a deduction to each separate limitation category. Also, see paragraph (f)(1)(iii) of this section with respect to the apportionment of deductions among the statutory groupings designated in section 904(d)(1). If the class of gross income to which a deduction has been allocated consists entirely of a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in one or more statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which deductions exceed gross income.